

SUBJECT
cc master.

SECRET



10 DOWNING STREET

LONDON SW1A 2AA

Meeting record.

From the Private Secretary

8 December 1987

THE MARKETS

The Prime Minister this evening discussed intervention policy with the Chancellor.

The Prime Minister expressed her very strong concern about the continued very large scale intervention needed to hold sterling below DM3. Intervention had totalled \$27 billion since the beginning of the financial year. We were in effect financing a substantial slice of the US current account deficit and certainly in recent weeks the Germans for example had carried out very little intervention. The fact that we were aiming to hold sterling below DM3 was itself stimulating speculation. There was a clear risk now that the liquidity created by our intervention would lead to renewed inflation. The latest forecast showed MO rising well above 6 per cent in the early months of next year.

The Chancellor argued that the effects of the intervention could be sterilised by extra funding or by intervention in the other direction when sterling came under downward pressure or by a combination of the two. Fears of inflation were exaggerated and any move through DM3 now would be very damaging to business confidence.

After further discussion the Prime Minister agreed that it would be worth attempting in the first instance to hold sterling below DM3 by intervening in DM rather than in dollars, in the hope that the scale of the intervention needed to achieve the objective would then be smaller. Whilst recognising that this would mean breaking the EMS agreement reached between central banks in March 1979, the Prime Minister asked the Chancellor to instruct the Governor, as agent for the Treasury in operating the EEA, to cease all intervention in dollars as from the opening of business in London tomorrow morning and to intervene instead in DM. The Chancellor should also step up the sales of gilts, needed to fund past intervention, preferably through index linked stock.

(DAVID NORGROVE)

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